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Credit Union Executive News

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NCUA PROPOSES MEMBER INSPECTION RIGHTS

In the most recent of its anti-conversion regulations, NCUA has proposed regulations to provide broad members' rights to access, inspect and copy credit union records. NCUA's intent was to provide members access to Board minutes and supporting documentation used by the Board in making decisions that would be subject to the members' vote. The theory being the member should be just as informed as the Board when casting his or her vote. Unfortunately, the proposed regulation goes far beyond access to documentation related to matters subject to membership vote and opens the door on nearly all credit union records, including CEO employment agreements.

The proposed Member Inspection Rights are problematic in many ways and if adopted in their proposed form, will expose credit unions to a wide variety of risks and certainly increased legal fees in dealing with credit union record requests and disclosures.

Overview of Rule

The proposed rule establishes sweeping new rights for members to inspect and copy nonconfidential portions of any credit union books and records of account and minutes of the Board.

Cont. p 2

Inside this issue:

PREPARING FOR THE UBIT GAME

With the Form 990 filing date two weeks away and a handful of newly issued IRS TAMs over the weekend declaring mainstream credit union products and services as unrelated, are you going to be paying UBIT this year?

Whether UBIT will apply to your credit union's product and service revenue streams will depend on the facts and law applicable to you—not the incomplete factual and legal analysis of the IRS in its recent UBIT TAMs.

TAMs Update

Out of the 14 Technical Advise Memoranda (TAM) issued by the IRS over the last two months, the score is 7 activities unrelated and subject to UBIT and 3 activities related and not subject to UBIT.

However, before you give the 7-3 score much thought, recognize that in the TAM game, the IRS is both a player and the umpire, a no lose lineup.

Cont. p 3

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NCUA PROPOSES MEMBER INSPECTION RIGHTS (CONT.)

Also the rule sets forth a series of five (5) procedural requirements to implement and support the inspection right including:

- Petition requirements to inspect records
- Inspection procedures
- Scope of available records
- Payment of records handling costs
- Dispute resolution

The inspection right is not an individual member right but a right of a group of members to petition for access and inspection of records. The petitioning group must involve 1% of the members with a maximum of 250 members—still a pretty easy standard to meet. The petition process itself is quite simple. The petition must include (i) a stated business purpose for access to the records (e.g., protecting the members' interests from mismanagement); (ii) the petitioners' agreement to pay for costs for searching and copying the records, but not any attorneys fees incurred in determining any nondisclosable records; and (ii) a declaration that the petitioners have not previously "sold" or "intend to sell" the credit union records (about as low of standard as there is). Given the ease and swiftness with which Wings Financial established an effective petition and signature gathering process, petitions for credit union records could become commonplace.

Problem Areas

We believe the proposed rule has a number of problem areas that deserve careful review, analysis and comment to NCUA. Here are some of the major ones.

Overbroad Scope of Records Access. The scope of credit union records accessible under the rule is practically limitless. First, the term "books and records of account" is undefined except for 3 narrow exclusions:

- records the disclosure of which is prohibited under federal law
- records that constitute nonpublic personal information under NCUA Privacy Rule (Part 716) or
- records the disclosure of which would be a clearly unwarranted invasion of privacy of employees or officials.

However, despite this apparent protection, the proposed rule specifically states records related to compensation and benefits provided to senior executive officers and qualifications of such employees are accessible. That leaves the door wide open for members to inspect and copy:

- Employment Agreements
- Deferred Compensation Plans
- Retirement Benefit Plans
- Insurance Benefits
- Employment applications, resumes and reference letters

In addition to compensation and benefit records, other credit union records are not necessarily protected such as: business plans, marketing strategies and similar confidential and proprietary information of the credit union. All minutes of the Board, Executive Committee and Supervisory Committee including: recordings, notes, presentations, etc. also may be freely accessible.

Typically, any request for corporate records from a credit union or private corporation must be founded upon a proper purpose. In the proposed rule, NCUA simply states that the purpose of inspection must be related to the business of the credit union and a proper purpose includes "attempting to ascertain and protect members' financial interests or ascertain possible mismanagement." This means members of FCUs now can conduct their own investigations of improprieties or mismanagement. Based on the proposed rule, so long as the members declare they will not "sell" the information, satisfying the petition requirements creates a presumption of a proper purpose. Only if the credit union has substantial evidence of an improper purpose can it deny records access. Even then, the decision is appealable to the NCUA Regional Director.

We believe NCUA's policy statements and assumptions for the weak protections afforded FCUs to guard their records are wrong. For example, according to the NCUA, the members' interest in senior management compensation and benefits outweighs any privacy interests of the senior management. At one point, NCUA concludes "credit unions do not generally have trade secrets…on which the success of the organization is dependent." How can NCUA be so ignorant of the tremendous amount of analysis and strategy Credit Unions undertake to successfully manage their affairs?

Cont. p 3

MEMBER RIGHTS (CONT.)

Credit Union Records Accessed by Members — No Protections. Do you want your 2007 Business Plan, branch expansion strategy, member marketing survey or CEO's Employment Agreement and Benefit Plan passed around without limits? Once any credit union record is accessed, inspected and copied by the members, the rule does not restrict members from making and distributing or even posting such information on a website for the entire world and any local banking competition to review.

While the credit union could ask the Regional Director for restrictions, the proposed rule affords no reasonable limitations on the further use or distribution of the credit union's records and no effective credit union remedies. Evidently, as long as the 250 members who signed the petition do not sell the information, the credit union should not be harmed.

Dispute Resolution—Not Independent

To the extent an FCU denies records access, the petitioning members may submit the dispute to the applicable NCUA Regional Director. The Regional Director has the total discretion in resolving the dispute, without any time requirements. Also, such decisions are not appealable to the NCUA Board. While the Regional Director has the authority to condition a records release upon entering a confidential agreement, you never know what you are going to get from the Regional Director. For example, recently an FCU client's nonstandard Bylaw amendment to correct an error in the model Bylaws was denied. So much for flexibility and reasonable discretion.

NCUA's proposed rule can be accessed at www.ncua.gov and the comment period ends June 22, 2007. As discussed above, for FCUs there are some real problems with the proposed rule that create considerable risk to the Credit Union. If you want assistance in preparing public comments to submit, please contact us as soon as possible. Of all of the recent anti-conversion regulations lately, this one goes far beyond establishing conversion protections and poses considerable threats to how you manage you Credit Union. Your comments are essential.

It is interesting that NCUA issued the proposed member inspection rights rule just three weeks after its proposed changes for FCUs to bolster their disaster recovery plans.

Any correlation…

Brian Witt

UBIT GAME (CONT.)

So far, the IRS has declared the following products and services subject to UBIT:

- AD&D Insurance
- Credit Life and Disability Insurance
- Guaranteed Auto Protection (GAP)
- Mechanical Breakdown Insurance (MBI)
- Financial Management-securities and financial planning
- Group Life, Health and Cancer Insurance
- ATM Nonmember Fees

The following activities were not subject to UBIT

- Sale of Checks
- Collateral Protection Insurance
- ATM Interchange Fees

The IRS' conclusions in the TAMs were fairly predictable and the application of these TAMs are still limited—only the 14 credit unions to whom they were issued. For other credit unions, it is a different game. For example, the statutory purposes of the credit unions in Arizona, Oregon and other states are much broader than Alabama or Connecticut. So to are the factual circumstances at every state chartered credit union on how such activities benefit their members and relate to their tax exempt functions.

The Flaws in the IRS Analysis

The IRS is not just calling a few strikes and balls. The IRS is using a 6-inch strike zone. The IRS call for nearly every one of the seven unrelated services above has gone like this: "The facts do not show how the sale of [XYZ] product contributes to the credit union's exempt purpose…and does little more than produce income for the credit union." Why is everything the credit union's pitch, high or outside or low and inside? Here's the strike zone.

Cont. p 4

PREPARING FOR THE UBIT GAME (CONT.)

Based upon a 1917 U.S. Attorney General opinion, (not any state credit union act or judicial decision) a credit union's tax exempt purpose is "promoting thrift and providing low cost credit." That's it. Unless the credit union's product or service hits this narrow space, it is out of the tax exempt purpose zone.

So far in the TAMs the IRS supports its narrow calls with the following justifications about the products and services:

- Credit union merely supports a third party's products/services
- Products do not promote savings
- Insurance is not required to get a loan
- Insurance does not aid in getting a loan
- Products offered to entire membership, not just to borrowers or savers
- Employee benefits in selling products, with no benefits to members

We believe the IRS' analysis is flawed in a number of key respects. First, the purposes of credit unions are not solely what the U.S. Attorney General thought in 1917. Court cases since then expressly hold that you look at state law (e.g., state credit union act purposes, etc.). Second, the IRS is requiring some objective link between the particular product or service and a savings account or loan. The link being—is it required to open the account or does it aid in obtaining the credit?

In most cases requiring an insurance product for a loan is illegal. More importantly, the fact that members can choose these financial products to improve their financial and social condition seems to be irrelevant. Incidentally, this latter condition is a key purpose of credit unions in some state credit union acts.

Preparing Your Credit Union for the UBIT Game

Credit unions need to prepare a thoughtful UBIT strategy immediately.

Don't Wait for the Perfect Case. Credit unions cannot wait for the "perfect case." In our view, that game may never get played. If the IRS can't win, they won't play. In other words, we do not see the IRS issuing the imperfect TAM/audit that can be litigated and lost.

UBIT Action Plan. We recommend that credit unions adopt a 4-prong UBIT strategy and action plan:

- Be proactive;
- Develop a UBIT policy;
- Strengthen product relationships to savings and loans; and
- Develop UBIT accounting procedures.

Credit unions should develop a UBIT policy that is supported by a careful evaluation and documentation of how your products and services serve your tax exempt purposes (savings, loans and other state law purposes). In addition, develop a business plan for each product and service that links revenue to member benefits (better savings rates, lower loan rates, etc.) and not just an isolated revenue stream. Last, identify and document revenue and expenses for each activity, whether you or the IRS determines it to be related or unrelated. If there is no net income, there is no UBIT.

The UBIT game isn't over, in fact for most credit unions the game hasn't even begun, but now is the time to prepare. Please call us if you need assistance in preparing or refining your credit union's UBIT strategy and action plan.

Brian Witt

OTHER FEDERAL REGULATIONS AND DEVELOPMENTS

There have been a number of developments at the federal level over the last month.

New FRB Regulations on Electronic Delivery of Disclosures. On April 20, the Federal Reserve Board (FRB) requested public comment on proposed amendments to five consumer financial service regulations (Regulations B, E, M, Z, and DD) to clarify the requirements for providing consumer disclosures electronically. The proposed amendments are intended to simplify the FRB's 2001 interim final rules which established uniform standards for the delivery of disclosures in electronic form. Currently, credit unions are not required to comply with the interim final rules under Reg B, E, M or Z, but must comply with the electronic delivery rules of

Cont. p 5

OTHER FEDERAL DEVELOPMENTS (CONT.)

NCUA Part 707 (Truth in Savings), as NCUA's rule is a final rule. The FRB subsequently lifted the mandatory compliance date for those final rules but NCUA did not provide similar relief.

According to the FRB, the proposal would simplify the FRB's interim rules by (1) withdrawing certain portions of the 2001 interim final rules that refer to the E-Sign Act; (2) withdrawing provisions of the interim rules that impose undue burden on electronic transactions and that are unnecessary for consumer protection; and (3) retaining certain provisions of the interim rules that provide guidance on the use of electronic disclosures.

The proposal would also implement certain provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which mandates certain disclosures for online credit card solicitations.

The comment period ends 60 days after publication of the notice in the Federal Register which is expected shortly. We will report on this again after the proposed rules are published.

New DOD Regulations. On April 11, the Department of Defense (DOD) issued proposed regulations implementing Section 670 of the John Warner National Defense Authorization Act.

The proposed regulations, DOD, Part 232, Limitations on Terms of Consumer Credit Extended to Servicemembers and Dependents, created a new layer of consumer credit rate requirements, in addition to Reg. Z, to better regulate the credit terms extended by creditors to active duty servicemembers and dependents. The proposed regulations provide for the following:

Definitions – Key credit terms are defined including: **Consumer Credit** (including payday loans, vehicle title loans, tax refund anticipation loans, but excluding residential and purchase money auto secured loans); **Creditor** (as proposed it includes all lenders including credit unions. However, the proposed regulation specifically seeks comments on excluding regulated financial institutions including credit unions); and **Military Annual Percentage Rate** "MAPR" (which includes finance charge items different than Reg. Z).

Loan Rate Cap – Loans to active duty service members and dependents are limited to 36% MAPR.

Disclosures – DOD proposes a specific "Covered Borrower Identification Statement" requiring borrowers to identify and disclose whether they are a member of the armed forces on active duty or a dependent protected by the regulation. In addition, the MAPR and payment obligation must be disclosed in a manner different that Reg Z.

Loan Limitations – The proposed regulation includes several unlawful terms and conditions including: (i) rollover, renewal or refinance terms that are not more favorable than the previous transaction; (ii) waiver of Servicemembers Civil Relief Act rights; (iii) arbitration clauses; and (iv) prepayment penalties fees.

Penalties – The DOD proposed rule contains harsh penalties for noncompliance including criminal misdemeanor penalties and void contract remedies.

The new regulations must be finalized by October 1, 2007.

Identity Theft. The President's Identity Theft Task Force recently released a strategic plan for combating identity theft. The plan focuses on ways to improve the effectiveness of criminal prosecutions of identity theft; enhance data protection for sensitive consumer information and provide more comprehensive and effective guidance for consumers and the business community; and improve recovery and assistance for consumers. The plan also includes several legislative proposals.

The Identity Theft Task Force was established in May 2006 and comprises of 17 federal agencies and departments including NCUA. The Task Force's strategic plan is posted on a centralized government web site on identity theft, www.idtheft.gov.

Brian Witt

Who stands behind your Credit Union compliance?

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LITIGATION DEVELOPMENTS

TJX Security Breach Class Action Lawsuit. On April 24, 2007, the Connecticut, Massachusetts and Maine Bankers Associations along with a number of individual banks announced that they are filing a class action lawsuit against TJX Companies Inc**.** following the security breach of data from approximately 45 million credit and debit cards. The breach was discovered in late December 2006, but TJX has reported that cards and other personal information may have been exposed going all the way back to 2003.

The plaintiffs in the TJX case have confidence that this lawsuit will achieve success even though lawsuits brought by other financial institutions as a result of a similar breach by BJ's Wholesale Club several years ago have achieved mixed results. The banking associations plan to allege unfair trade practices claims against TJX, a claim not brought in the BJ's cases argued in Pennsylvania. In addition, the TJX plaintiffs will seek to prove that TJX is responsible for negligent misrepresentation. According to the plaintiffs, the TJX companies represented that they were safeguarding and disposing of cardholder data and these representations were not true and showed a lack of reasonable care under Massachusetts law.

We think this is a particularly interesting case to follow as we frequently assist credit union clients in contract reviews and negotiations to protect member data provided to and stored by service providers. These contract provisions typically include representations that data will be safeguarded the same that TJX represented the data it stored would be protected.

More Centrix Fall Out. On March 14, 2007, a Delaware insurance company, Everest National Insurance Company, filed suit against Centrix owner Robert Sutton and others for fraud and conspiracy related to substantial losses the insurance company suffered from providing default protection insurance (DPI) coverage. In the lawsuit, the insurance company alleges that Sutton through Centrix (now in bankruptcy) intentionally concealed and misrepresented many aspects of the Centrix portfolio management program (PMP) which purportedly utilized legitimate "A" rated insurance company to provide DPI and VSI insurance to the credit union lenders. Among the many fraud claims was Centrix's failure to disclose that the VSI insurance actually lapsed after Centrix failed to pay the VSI premiums.

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